INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute and regulations involved	3
Statement	3
Summary of argument	9
Argument:	
I. The taxpayer corporations are taxable on the profits which they earned in carrying on their respective businesses	12
A. By imposing a tax on corporations, Congress has required that income earned by the corporation be taxed to it	12
B. The undisputed facts show that the income was earned by the taxpayer corporations and not by their parent company	15
C. No principle permits the corporations' income to be regarded, at its instance, as having been earned by the sole stockholder	30
D. The Tax Court did not hold that the taxpayers were the agents of their parent corporation	40
E. The taxpayers did not act as agents for their parent corporation	44
F. The taxpayer corporations, by agreeing to pay their profits to their parent stockholder, did not incur deductible business expenses	52
II. The Court of Appeals possessed authority to reverse erroneous decisions of the Tax Court	57
Conclusion	60
Appendix	61

CITATIONS

Cases:

American Cigar Co. v. *Commissioner*, 66 F. 2d 425, certiorari denied, 290 U. S. 699 — 23

Bankers Coal Co. v. *Burnet*, 287 U. S. 308 — 57

Bingham, Trust of v. *Commissioner*, 325 U. S. 365 — 58

Bourjois, Inc. v. *McGowan*, 85 F. 2d 510 — 28

Burnet v. *Commonwealth Imp. Co.*, 287 U. S. 415 — 9, 13, 14, 19, 20, 24, 36, 48

Burnet v. *Leininger*, 285 U. S. 136 — 15

815888—48——1

Cases—Continued

	Page
Campana Corp. v. Harrison, 114 F. 2d 400	28
Campana Corp. v. Harrison, 135 F. 2d 334	28
Commissioner v. Estate of Holmes, 326 U. S. 480	58
Commissioner v. Heininger, 320 U. S. 467	57
Commissioner v. Sunnen, 333 U. S. 591	15, 27
Commissioner v. Tower, 327 U. S. 280	15
Commissioner v. Wilcox, 327 U. S. 404	58, 59
Crane v. Commissioner, 331 U. S. 1	58
Dobson v. Commissioner, 320 U. S. 489, rehearing denied, 321 U. S. 231	58
Douglas v. Willcuts, 296 U. S. 1	15
Edwards v. Chile Copper Co., 270 U. S. 452	13
General Utilities Co. v. Helvering, 296 U. S. 200	57
Gregory v. Helvering, 293 U. S. 465	29
Griffiths v. Commissioner, 308 U. S. 355	29
Gulf Oil Corp. v. Lewellyn, 248 U. S. 71	33, 36
Harrison v. Schaffner, 312 U. S. 579	15
Helvering v. Clifford, 309 U. S. 331	15, 26
Helvering v. Eubank, 311 U. S. 122	15
Helvering v. Horst, 311 U. S. 112	15
Higgins v. Smith, 308 U. S. 473	13, 30
Interstate Transit Lines v. Commissioner, 319 U. S. 590	14, 54
Lucas v. Earl, 281 U. S. 111	15, 26, 30
Lusthaus v. Commissioner, 327 U. S. 293	15
Lynch v. Hornby, 247 U. S. 339	35, 36
McWilliams v. Commissioner, 331 U. S. 694	58
Minnesota Tea Co. v. Helvering, 302 U. S. 609	29
Moline Properties v. Commissioner, 319 U. S. 436	9, 13, 14, 19, 20, 24, 37, 38, 49, 52
Munson S. S. Line v. Commissioner, 77 F. 2d 849	37, 42
New Colonial Co. v. Helvering, 292 U. S. 435	13
Nixon v. Lucas, 42 F. 2d 833	37
North Jersey Title Ins. Co. v. Commissioner, 84 F. 2d 898	38, 42
Pepper v. Litton, 308 U. S. 295	23
Raybestos-Manhattan Co. v. United States, 296 U. S. 60	14, 27, 54
Railway Express Agency v. Commissioner, 167 F. 2d 193, pending on petition for certiorari, No. 247, this Term	44
Southern Pacific Co. v. Lowe, 247 U. S. 330	30, 31, 32, 33, 37, 38, 39, 42
Tennessee-Arkansas G. Co. v. Commissioner, 112 F. 2d 508	24
United States v. Joliet & Chicago R. Co., 315 U. S. 44	10, 13, 14, 26, 28, 30, 54
United States v. Phellis, 257 U. S. 156	30
Statutes:	
Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess.:	
Sec. 36	58
Sec. 38	58

Statutes—Continued

	Page
Internal Revenue Code:	
Sec. 141 (26 U. S. C. 141)	51
Sec. 1141 (26 U. S. C. 1141)	58
Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 240	50
Revenue Act of 1921, c. 136, 42 Stat. 227:	
Sec. 240	50
Sec. 1331	50
Revenue Act of 1924, c. 234, 43 Stat. 253, Sec. 240	50
Revenue Act of 1926, c. 27, 44 Stat. 9, Sec. 240	50
Revenue Act of 1928, c. 852, 45 Stat. 791, Sec. 142	50
Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 141	50
Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 141	51
Revenue Act of 1936, c. 690, 49 Stat. 1648, Sec. 141	51
Revenue Act of 1938, c. 289, 52 Stat. 447:	
Sec. 13	13, 61
Sec. 22	61
Sec. 23	52, 61
Sec. 45	53, 62
Sec. 141	51
Sec. 602	13, 62
Revenue Act of 1942, c. 619, 56 Stat. 798, Sec. 159 (26 U. S. C. 141)	51
Revenue Act of 1943, c. 63, 58 Stat. 21:	
Sec. 131 (26 U. S. C. 141)	51
Sec. 204 (26 U. S. C. 141)	51
Tax Adjustment Act of 1945, c. 340, 59 Stat. 517, Sec. 2 (26 U. S. C. 141)	51
Miscellaneous:	
Restatement of the Law of Agency:	
Sec. 12	47
Comment to Sec. 12	48
T. D. 4829, 1938–2 Cum. Bull. 98	63
Treasury Regulations 101:	
Art. 13–1	63
Art. 22 (a)–1	63

In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 151

NATIONAL CARBIDE CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 152

AIR REDUCTION SALES COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 153

PURE CARBONIC, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 6–35) are reported at 8 T. C. 594. The

opinion of the Court of Appeals (R. 274–280) is reported at 167 F. 2d 304.

JURISDICTION

The judgments of the Court of Appeals were entered on March 31, 1948 (R. 281–283). A petition for rehearing (R. 284–288), filed on April 15, 1948, was denied on April 19, 1948 (R. 288). A petition for writs of certiorari was filed on July 14, 1948 (R. 290), and was granted on October 11, 1948 (R. 289). The jurisdiction of this Court is conferred by 28 U. S. C. 1254.

QUESTION PRESENTED

The taxpayers are regularly organized corporations, owning valuable assets and employing officers and employees. They are engaged in businesses in which they utilize those assets and the services of their employees to manufacture products which they sell to the public at a profit. All of their capital stock is owned by a common parent corporation, to which, by written contract, they have agreed to pay over all except a nominal part of their earnings.

The question is whether the Court of Appeals was correct in holding that the taxpayers were taxable on all the income which they earned, and in reversing the Tax Court which had ruled that they were not taxable on the portion of their income which they paid over or credited to the parent corporation pursuant to their agreement.

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and other authorities involved are set forth in the Appendix, *infra*, pp. 61–63.

STATEMENT

These proceedings involve asserted deficiencies in income and declared value excess profits taxes for the calendar year 1938 (R. 6). The following is a summary of the findings of fact of the Tax Court which are deemed to have a material bearing on the controversy.

The taxpayers are: National Carbide Corporation, Air Reduction Sales Company, and Pure Carbonic, Inc., sometimes referred to, respectively, as "Carbide," "Sales," and "Carbonic." Each taxpayer is a separately organized corporation and all of the capital stock of each is owned by Airco Reduction Company, Inc., which will be referred to as "Airco" or the parent company. The taxpayers possessed only a nominal capitalization, *i. e.*, Carbide's outstanding capital stock was 50 shares of $100 par value per share, Sales had 125 shares of $100 par value, and Carbonic had 50 shares of $100 par value. (R. 8, 12.)

Each of the taxpayers is engaged in the manufacture and sale of the following products: Sales—the gaseous constituents of air, hydrogen, acetylene, and tools and apparatus for the utilization of these gases, as well as containers for the transportation of acetylene gas; Carbide—cal-

cium carbide used in the making of acetylene gas, part of the product being used by Sales and the remainder being sold to customers who manufactured acetylene; Carbonic—carbon dioxide in gaseous and liquid form (carbonic acid gas) and also in solid form (dry ice). Another subsidiary of Airco, Wilson Welder & Metals Company, Inc. (referred to as Welder), which is not one of the taxpayers, was engaged in the manufacture, assembly and sale of electric arc welding machines, welding rods, equipment and supplies. (R. 8–9.)

The corporate existence and business of the taxpayers, as they existed during the taxable year, are the products of long and somewhat involved histories only the outlines of which need be sketched. From the time of Airco's establishment in 1915, it organized or acquired control of numerous subsidiary companies. It acquired the stock of these companies either by paying cash or issuing its own stock for the capital stock of those companies. Thereafter, Airco brought about a simplification of the underlying corporate structures. It did this by dissolving, merging and consolidating these numerous subsidiaries so that, during the taxable year, its principal subsidiaries were the three taxpayer corporations and Welder (R. 12–21).

In this process of simplification, title to the principal assets, consisting of plant, machinery, equipment, etc., previously owned by numerous subsidiaries, was transferred to the three tax-

payers at Airco's direction.[1] Airco also acquired the assets and businesses of other corporations and title to those assets was in turn transferred to the taxpayers. Airco, in addition, supplied the taxpayers with a certain amount of initial working capital in the form of cash. (R. 12–13, 14, 16, 20.)

Either as originally incorporated or because of subsequent reductions, the taxpayers possessed only a nominal capitalization. That capitalization was not increased to reflect the value of the assets, title to which was acquired by the taxpayers in the manner described, and which they employed in their respective businesses. Instead, each taxpayer showed a book indebtedness to the parent for the value of those assets as well as for the cash with which they were supplied for working capital. (R. 21–22.) In the course of the operation of their businesses, the taxpayers purchased and acquired title to additional assets. The value of these was also reflected in the form of a book-indebtedness to the parent. The only assets used by the taxpayers which did not belong to them and which, instead, were owned by the parent, consisted of certain gas cylinders. These cylinders were allocated to the various taxpayers by the parent as needed, but no rental or other charge was made for their use.

[1] No further mention is made of Welder since it is not involved in this case.

The parent company and each of the taxpayers (or a predecessor in interest) had entered into separate agreements which were in effect during the taxable year. The agreement between the parent and Sales, which is typical, provided as follows (R. 13–14):

> That for good and valuable considerations each to the other given and received, the parties hereto hereby agree as follows:
>
> First.—Airco hereby employs Sales as its agent to manage and operate, during the term of this contract, all plants for the production of oxygen, acetylene and other gases and for the manufacture of apparatus and containers for the utilization and transportation of such gases, which it or its subsidiary or controlled companies now own or control, or which it or they may hereafter build or acquire; and likewise employs Sales as its agent to market and sell, during the term of this contract, the output of all such plants.
>
> Second.—This contract, and the said employment of Sales hereunder, shall continue until December 31st, 1917; and thereafter shall continue from year to year subject to the right of either party to terminate the same at any time by giving thirty days previous written notice to the other of its intention so to do.
>
> Third.—Airco agrees (1) to give Sales the use of all cylinders, containers, motor trucks, equipment, and shipping facilities, which it now owns or may hereafter ac-

quire; (2) to supply such working capital as Sales may need; (3) to provide such executive management (but not accounting, bookkeeping and clerical service), and office accommodation and facilities, as may be necessary for the proper conduct of Sales business; and (4) to procure for Sales such contracts with Airco's subsidiary or controlled companies as will enable Sales to exercise in each case the agency hereby created, and as will in each case constitute Sales the agent of such subsidiary or controlled company.

Fourth.—Sales agrees (1) to manage and operate efficiently and carefully all of said plants; (2) to maintain the same in first class condition, charging necessary repairs and replacements to operating expense and setting aside and charging to operating expense proper reserves for depreciation and for wear and tear not immediately replaceable by repairs; (3) to distribute, market and sell, the product manufactured in said plants as efficiently as possible, realizing, to the best of its ability, the largest obtainable gross receipts therefrom; (4) to pay all expenses of such operation, maintenance and selling, and to discharge all expenses or liabilities incurred therein or thereby and to collect all accounts receivable or other proceeds resulting therefrom; (5) to credit monthly on its books to Airco all profits accruing to it from the operation of its entire business over and above an amount equal to

six per cent. (6%) per annum on its outstanding capital stock, which said amount it is hereby authorized to deduct and retain, and it hereby agrees to accept as full compensation for its services hereunder; and (6) to pay over to Airco upon demand any profits becoming due and credited to Airco as aforesaid.

Pursuant to the agreements, the taxpayers (in addition to the indebtedness reflecting the value of all their assets) credited to the accounts payable to the parent the net proceeds from their business operations, minus the nominal amounts which they purported to accept as payment for their services under the agreements. No interest ran on any of the accounts payable to the parent. (R. 21–22.)

As the sole stockholder, and by means of common directors and officers, the parent company dominated and controlled the subsidiaries in the conduct of their respective businesses. In certain respects, this control extended to the minutest detail. The parent was thereby also able to achieve a certain integration and correlation of the business activities of the taxpayers. All transfers of materials and supplies between one taxpayer and another were clearly reflected on their books. (R. 22–28.)

Asserted deficiencies in income and declared value excess profits taxes for the taxable year 1938 resulted from the Commissioner's determi-

nations that the income of each taxpayer should include the entire earnings from its business activities and not merely the amounts which had been credited to its own accounts as being due under the so-called "agency" contracts (R. 6–11, 38–42). The Tax Court, Judges Van Fossan, Arnold and Opper dissenting, refused to sustain the Commissioner's deficiency determination (R. 29–35). The Court of Appeals reversed the Tax Court and reinstated the Commissioner's deficiency determinations (R. 274–280).

SUMMARY OF ARGUMENT

I

The taxes which are involved in these cases have been imposed by Congress on corporations as separate tax entities. The taxing statute thus recognizes that the corporation and its stockholders are distinct taxpayers and that the corporation must be taxed on the income which it earns in the conduct of the corporate business. Even though all its stock is owned by a single individual or by another single corporation, the income earned by the corporation remains taxable to it. *Moline Properties* v. *Commissioner*, 319 U. S. 436; *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415. The corporation remains taxable on income attributable to the corporate property even though the payments are made by the transferee directly to the stockholders and even though

the corporation has divested itself of all control over the property. *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44. Nor may these tax results be avoided by an arrangement in which the corporation and its stockholders agree that the corporation's income shall be considered as belonging to the stockholders. Such an agreement is no more effectual in shifting tax liabilities than is any other kind of anticipatory arrangement whereby income is assigned from the person who earns it to another who does not.

The taxpayers here are corporations engaged in the business of manufacturing products and selling them to the public. In carrying on this business, they utilize assets of considerable magnitude which they own in their corporate capacities and they utilize the services of their own officers and employees whom they employ in their corporate capacities. As a result, the taxpayer corporations are taxable on the profits which they create in the conduct of their corporate businesses, in the same fashion as is any other corporation. This tax liability cannot be shifted at their instance to their sole stockholder, a parent corporation, because of any supposed rule of law permitting their corporate entities to be disregarded, as the Tax Court held, or because, as the taxpayers now argue, they and their parent have agreed that the parent should be the owner of the taxpayers' profits as a "principal."

There are no facts in this case which would permit the conclusion that the taxpayers were acting as agents for their stockholder, the parent company. Nor did the Tax Court decide otherwise. Though labelled a contract of agency, the agreement that the parent company should be the owner of the income is, in the circumstances of this case, no different from a simple anticipatory assignment of future income which will not relieve the assignor from tax. Nor may the taxpayers achieve the same result by claiming that, in agreeing to pay over their profits to their stockholder, they have incurred deductible business expenses. The stockholder will normally receive his interest in the corporate profits through the channel of dividends. A deductible ordinary and necessary business expense does not arise out of a corporation's advance agreement to pay over its profits to its stockholder.

II

The authority of the Court of Appeals was not so limited as to make a reversal of the Tax Court's decision improper in this case. Whether the Tax Court's decision be regarded as one in which it applied a wrong principle of law, or one in which it drew a conclusion which lacked any rational support in the record, or a combination of both, its decision was wrong and the Court of Appeals was required to correct it.

ARGUMENT

I

THE TAXPAYER CORPORATIONS ARE TAXABLE ON THE PROFITS WHICH THEY EARNED IN CARRYING ON THEIR RESPECTIVE BUSINESSES

A. BY IMPOSING A TAX ON CORPORATIONS, CONGRESS HAS REQUIRED THAT INCOME EARNED BY THE CORPORATION BE TAXED TO IT

The ultimate question in these cases is whether a corporation, as the Court of Appeals held, is to be taxed on its income where (1) the corporation is regularly organized, (2) it utilizes assets which it owns and the services of its own officers and employees to manufacture products which it sells to the public at a profit, but (3) it has agreed to pay over the most considerable part of its earnings to its sole stockholder by direct payments rather than in the form of dividends.

We believe that the consistent course of decisions of this Court permits the question to be answered in only one way, namely, that such income must be taxed to the corporation, and that the taxable incidence may not be shifted at its instance to its parent. The answer must be the same, moreover, whether the problem is expressed in terms of disregarding corporate entities, as the Tax Court did in its opinion, or in terms of principal and agent, as the taxpayers now attempt to explain the matter. The Court of Appeals, in deciding that the income in ques-

tion must be taxed to the taxpayer corporations, reached the only permissible result.

By imposing an income tax on corporations, Congress has selected a juristic entity for taxation.[2] The statute makes the corporation and its stockholders separate and distinct taxpayers. Each is taxable on its own income; the corporation on the income which is earned by it in conducting the corporate business, the stockholder on the income which he earns. The stockholder's income, of course, will include such income (dividends, for example) which may derivatively flow to him from the corporation because of his stock ownership. *Moline Properties* v. *Commissioner*, 319 U. S. 436; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44; *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415; *Higgins* v. *Smith*, 308 U. S. 473, 477–478; *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 442; *Edwards* v. *Chile Copper Co.*, 270 U. S. 452, 456.

A necessary concomitant of this principle is the conclusion that the taxable income of the corporation retains its separate identity even

[2] Section 13 (b) of the Revenue Act of 1938 (Appendix, *infra*, p. 61), with certain exceptions not material here, imposes a tax on the income of every corporation having net income in excess of $25,000. Section 602 (Appendix, *infra*, p. 62) imposes a tax on every corporation liable for the capital stock tax under Section 601, the tax being on net income in excess of 10 percent of the adjusted declared value of its capital stock. Liability for income and declared value excess profits taxes is involved in these cases.

though all its stock is owned by one individual or by another single corporation. This is so because Congress, having drawn the line so as to make a clear division between the corporation and its stockholders, has plainly decreed that this dichotomy must exist for tax purposes even though the corporation is only a fictitious being created by local law, and even though, in many respects, the separation between the sole stockholder and the corporation may be an economic formalism. The corporation, therefore, not its sole stockholder, is by statute declared to be the economic earner of the profits created through its corporate business activities. *Moline Properties* v. *Commissioner, supra; Burnet* v. *Commonwealth Imp. Co., supra;* cf. *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590.

The present cases also necessitate the application of another, but equally fundamental, principle which requires that income be taxed to the taxpayer who earns it, and which ignores as ineffectual any arrangement by which such income is deflected to or channeled through another. Thus, a corporation is taxable on income attributable to the corporate property even though it has caused the income to be paid directly to its stockholders and has relinquished the right to receive the income itself. *United States* v. *Joliet & Chicago R. Co., supra.* Cf. *Raybestos-Manhattan Co.* v. *United States,* 296 U. S. 60. The *Joliet* case, involving a corporate taxpayer, is but a

specific example of how this Court, in various situations, has held a wide variety of such anticipatory assignments to be ineffective for the purpose of shifting tax liabilities. *Commissioner* v. *Sunnen*, 333 U. S. 591; *Commissioner* v. *Tower*, 327 U. S. 280; *Lusthaus* v. *Commissioner*, 327 U. S. 293; *Harrison* v. *Schaffner*, 312 U. S. 579; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Eubank*, 311 U. S. 122; *Helvering* v. *Clifford*, 309 U. S. 331; *Douglas* v. *Willcuts*, 296 U. S. 1; *Burnet* v. *Leininger*, 285 U. S. 136; *Lucas* v. *Earl*, 281 U. S. 111.

B. THE UNDISPUTED FACTS SHOW THAT THE INCOME WAS EARNED BY THE TAXPAYER CORPORATIONS AND NOT BY THEIR PARENT COMPANY

The Tax Court, while recognizing the general applicability of the principles just summarized, took the view that there is another principle of law, announced by this Court in *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, which, in certain exceptional circumstances, demands that a corporate entity be ignored for tax purposes. We shall show, in Point I C, *infra*, pp. 30–40, that the decision in the *Southern Pacific* case has no application to the facts of this case, no matter how they be viewed. Before doing so, however, we will, in this section of the brief, analyze those facts which the Tax Court deemed significant in order to demonstrate that, contrary to the legal conclusion reached by the Tax Court, every reason exists in these cases for giving positive affirma-

tion to the general principles, already outlined, which require that the income be taxed to the taxpayer corporations.

The Tax Court said (R. 30–32):

> We summarize as follows some of the facts which have brought us to this conclusion: The capital stock of each petitioner [taxpayer] is nominal in amount and is all owned by Airco. The members of the board of directors of each petitioner are elected by Airco and, with one exception, they are all senior executive officers of Airco. The chairman of the board of directors of Airco was also chairman of the board of directors of each petitioner. The president of Airco was also a director of Airco and of each petitioner. The Airco board held regular meetings and exercised complete domination and control over the business of Airco and each of the petitioners. The board of directors of the petitioners held an organization meeting each year and thereafter only met when called upon by Airco to formalize action taken by the Airco board. The chairman, vice-chairman and president of Airco were in charge of the administration and management of the activities of each petitioner and carried out the policies and directives with respect to each petitioner as promulgated by the Airco board. One main office was maintained for Airco and the petitioners in the Lincoln Building, New York, N. Y., and, with two minor exceptions, the offices of

all the executive officers of Airco and the petitioners were located there. * * * The business of the parent and the petitioners was conducted as one business unit divided into six branches: corporate operations, sales, financial, distribution and research. Each of the six main branches was directed by a senior officer of Airco. The subdivisions of each of the six branches were also directed and managed by officers of Airco. All employees in each of the six branches performed their duties for Airco and each petitioner whenever and wherever their services could be utilized in connection with the operations of any of the petitioners. All expenditures for Airco and each petitioner of more than $500 required specific approval of the Airco board of directors and its chairman. * * * All purchases for each petitioner from persons outside the affiliated group, except emergency purchases up to $50, were made only upon orders issued by the general purchasing agent of Airco. Products produced by or materials purchased for one agency company were often transferred to another agency company. Where this was done the transfer was reflected on the intercompany accounts at cost without the passage of any cash. There were no intercompany profits. All bank accounts maintained in the name of each petitioner were treated by Airco as its own and were drawn upon indiscriminately by it when money was

> needed by any company. There was substantial identity of officers authorized to sign checks on the bank accounts of Airco and on the bank accounts of each petitioner. All credits and collections were in charge of the Airco credit manager. Airco maintained pension systems for all employees of all companies. Accounting was done for all companies by one general accounting office under the general auditor of Airco and accounting procedure was uniform. * * *

These facts could be more tersely summarized by concluding that the parent corporation, as the sole stockholder, exercised complete and ultimate control over each of these subsidiaries, and that each of the subsidiaries here conducted its business in accordance with the dictates of its sole stockholder. While the pattern here is more complex, the situation is not essentially different from that which exists where an individual is the sole stockholder of a corporation. In both instances, the stockholder's control over the affairs of the corporation is equally stringent. In both situations, the corporation carries out the mandates of its stockholders with the same degree of subservience. Indeed, it would require the greatest naivete to assume that such a corporation does not, in the final analysis, conduct its business to conform to the purposes of its single stockholder, whether that stockholder be an individual, as in

the *Moline Properties case* (319 U. S. 436), or an estate, as in the *Commonwealth Imp. Co.* case (287 U. S. 415), or another corporation, as here.[3]

The Tax Court, however, failed to appreciate that the existence of the corporation as a taxable entity does not turn on the number of its stockholders or on the degree of supervision and control to which it is subjected. The actions of the board of directors, however much they may be dictated by even the sole stockholder, constitute the action of the corporation and not of the stockholder. This cannot be gainsaid by characterizing the director's decisions, as did the Tax Court here, as serving only to "formalize" the desires of the stockholder. Likewise, the actions of any officer or employee of a corporation are no less the actions of the corporation because that person may be the stockholder or hold a position with a stockholding parent. These are not only truisms of general corporate law; they are equally vital in the taxation of corporations. They show that the corporation is the earner of, and is taxable on, the profits which it creates, and that the corporation's income is not the stockholder's in-

[3] Petitioner seeks to distinguish the *Moline* case as being one in which the corporation was "'clearly not'" the sole stockholder's "'*alter ego*'" and "'that his exercise of control over it was negligible.'" (Br. 18.) But as the opinion of this Court makes clear (319 U. S. at 440), the Court, at that point, was speaking of a period earlier than the tax years involved in the case. Later, "in 1933" as this Court stated, "control of petitioner reverted" to the sole stockholder. 319 U. S. at 437

come even though there is but a single stockholder, and even though this stock ownership enables the sole stockholder to control the corporation in every respect. *Moline Properties* v. *Commissioner*, 319 U. S. 436; *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415.

The Tax Court also pointed out (R. 31) that:

> Advertising was conducted under one advertising manager and through this medium Airco represented to its stockholders and the general public that the petitioners [taxpayers] were divisions of the parent company.

Again, it is difficult to perceive how this fact could have any possible bearing on the tax result. Whatever representations were made by the parent to its stockholders, or to the public, cannot nullify the corporate existence of the subsidiaries or obscure the substantial business activities in which they were engaged. Moreover, it will be noted that the Tax Court does not deny that the subsidiaries were represented to the stockholders and to the public as being separate corporations. The evidence, it is believed, would admit of no dispute on that point.[4]

[4] See Respondents' Exhibits 25–30. (The original exhibits in this case are not printed as part of the record in this Court but are on file in the office of the Clerk.) These exhibits actually show that the taxpayers were represented to the public as separate corporations. There is no evidence to the contrary.

The Tax Court also believed it to be significant that (R. 31):

> All assets held by each petitioner [taxpayer] were furnished to it by Airco which paid for them with its own cash or stock. Airco supplied all the working capital of each petitioner.

The more detailed findings of fact concerning the method by which the taxpayer corporations were financed appear at R. 12–20, 21–22. They show that, while each of the subsidiary corporations was given only a nominal capitalization, the parent company had consolidated in each of the taxpayers the assets of numerous other corporations. While there is no explicit finding on this, it is undisputed that title to these assets was transferred to the taxpayers and that they acquired title to additional assets by purchases made in the course of their business operations. Each subsidiary, on its books, showed an indebtedness to the parent reflecting the value of all those assets. The parent had supplied each subsidiary with initial working capital, and each was permitted to augment this, to the extent necessary, out of earnings. The subsidiaries also showed a book indebtedness to the parent for the amount of all working capital. It was in this manner that the parent "furnished" and "supplied" the assets and working capital which, it should be emphasized, were owned by the subsidiaries.

What significance, then, is there in the circumstance that part of the capital utilized by the taxpayer-corporations here originated with the stockholder, and that part was derived from the reinvestment by the taxpayers of their own earnings in their businesses? The assets of any corporation are a combination of the capital contributions made by the stockholders, the funds which the corporation is able to borrow, and the earnings which the corporation is able to reinvest in the business. Where there is a single stockholder, of course, the entire capital contribution must originate with that stockholder. The important thing is that every corporation (even where it has only one stockholder) is the owner of the assets derived from those funds. Where the corporation is engaged in a business in which those assets are employed, it is the owner of the earnings thereby created, and the entity to which those earnings are taxable.

In the present case, the amount of the assets of the subsidiaries which the parent furnished in the form of capital stock contributions is nominal. The amount of the assets which it purported otherwise to contribute, and for which the subsidiaries showed a book indebtedness to the parent, is most substantial. It is not necessary, in the present controversy, to determine whether the latter are truly loans or constitute additional capital contributions. If it were pertinent here, it might be observed that the absence of a definite

time being specified for repayment, the fact that no interest was payable on the purported indebtedness, and the inability of the subsidiaries ever to make repayment except upon dissolution,[5] would, altogether, be strongly persuasive that the parent did not intend to make loans which would be repaid, and that this was only a capital contribution which enhanced the stockholder's equity in the subsidiary corporations. *American Cigar Co.* v. *Commissioner,* 66 F. 2d 425 (C. C. A. 2d), certiorari denied, 290 U. S. 699. Cf. *Pepper* v. *Litton,* 308 U. S. 295.[6] At all events, whether the assets owned by the subsidiaries were acquired by way of capital contributions or by way of borrowed capital, the ultimate fact remains that these assets were owned by the subsidiaries and were employed in their respective businesses. The circumstances that the capital, in one form or another, all emanated from a single stockholder

[5] The value of the total assets owned by each taxpayer was almost equivalent to its book indebtedness to the parent. Respondents' Exhibits A, B, and C. Since the taxpayers, in addition, were purportedly under an obligation to pay over to the parent each year substantially all their earnings, there was no way in which they could pay off the indebtedness for their assets, short of dissolution.

[6] The Court in *Pepper* v. *Litton*, *supra*, said (pp. 309–310):

> And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder * * * where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan.

does not serve to insulate the corporation against being taxed on the income which it earned or to impute that income to its single stockholder. *Moline Properties* v. *Commissioner,* 319 U. S. 436; *Burnet* v. *Commonwealth Imp. Co.,* 287 U. S. 415.

Although, in its summary of the significant facts on which it based its decisions (R. 30–32), the Tax Court made no mention of this, its detailed findings of fact show that the parent company retained the title to all gas cylinders (other than acetylene cylinders) and that these were allocated to the various subsidiary companies as required by them (R. 21). Each cylinder had a value of about $15 or $16 (R. 18) and the parent company, in 1938, owned approximately 850,000 cylinders of which 600,000 were in service for Sales and 250,000 for Carbonic (R. 27). The subsidiaries, apparently, were not charged on the books for the use of these cylinders.

These were the only assets used by the subsidiaries which they did not own. It need not be decided whether the use of the cylinders, too, should be viewed as a contribution to capital, for the taxpayers, below, made no claim that the free use of the cylinders resulted in a distortion of their income, and introduced no evidence as to what would have been a reasonable charge for their use. Cf. *Tennessee-Arkansas G. Co.* v. *Commissioner,* 112 F. 2d 508, 510 (C. C. A. 6th). See pp. 52–57, *infra.*

The final circumstances relied on by the Tax Court were (R. 32):

> The proceeds realized from each petitioner's [taxpayer's] activities did not come to Airco as the result of any independent action by the agency company, such as declaration of dividends. A written operating agreement was entered into between Airco and each petitioner under which the petitioner agreed to conduct a branch of the Airco business for a purely nominal fee. In each agreement the agency company agreed to credit, and did credit, monthly on its books to Airco all profits from its operations above the nominal amount of its compensation. The accounts between Airco and each petitioner were kept strictly in accordance with each operating agreement.

The Tax Court, we submit, however, was altogether wrong in concluding that these agency contracts, whatever their legal effect as between the parties themselves, could avail to transform the earnings of the subsidiaries into earnings of the parent. The agreements cannot alter the indisputable circumstance that the subsidiaries, which own the assets and perform the services, are the earners of the profits thereby created and that the parent is not.

That these earnings did not come to the parent through the normal means of dividends being declared by the subsidiaries does not have the

least significance, although the Tax Court believed the contrary to be true. The situation here, in that respect, is governed by *United States v. Joliet & Chicago R. Co.*, 315 U. S. 44. There the corporation leased all its property in perpetuity, the lessee undertaking to make annual payments directly to the corporation's stockholders. The corporation thereafter carried on no active business. It was held, nevertheless, that those payments constituted income taxable in the first instance to the corporation. The Court pointed out that the relationship between the corporation and its stockholders was an abiding one, and that the right of the stockholders to receive the payment was derivative only. That is, the stockholders received the payments because they were stockholders since (p. 48)—

> * * * the rental or purchase payments for the property conveyed by respondent [the corporation] could not lawfully be paid to another without its authority; and it could not lawfully dispose of them to others without the consent of its shareholders.

Accordingly, it was held that the corporation, by causing the payments to be made directly to its stockholders, was no more relieved of tax than would be true in any other situation where the owner of property attempted to assign the income from that property to another, the opinion citing *Lucas v. Earl*, 281 U. S. 111, and *Helvering*

v. *Clifford*, 309 U. S. 331. As a result, the corporation and its stockholders in the *Joliet* case were in the same taxable situation as would have been true if the payments from the transferee of the property had been first received by the corporation and then paid out by it in the form of dividends to its stockholders. Accord: *Raybestos-Manhattan Co.* v. *United States*, 296 U. S. 60. The same must be true here where the payments are made to the stockholder pursuant to a contract which seeks to avoid the normal channel of dividend declarations.

Actually, the present cases are *a fortiori* situations for the taxation of the income to the corporation since here the taxpayer corporations carried on business activities of major proportions in the course of which they received the income from the purchasing public, while, in the *Joliet* case, the taxpayer corporation did nothing of an active nature, not even to the extent of collecting the income.

In the final analysis, therefore, the agency agreements here can have no different effect than any other anticipatory assignment of income. Each subsidiary, by a combination of the assets which it owned and the services which it performed, was the earner of the income in question. It is fundamental that the income must be taxed to such earner and that this cannot be avoided by any anticipatory arrangements regardless of the form that they assume. *Commissioner* v. *Sunnen*, 333 U. S. 591, and the other cases cited *supra*,

p. 15. It is also fundamental that a corporation may not attribute the corporate income to its stockholders. Therefore, the subsidiaries here, by agreeing to pay over their earnings to their stockholder and by crediting those amounts on their books, can no more relieve themselves from being taxed on their earnings than the taxpayers in the cases cited above, including *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44.

Since the relationship between a parent corporation and its subsidiaries presupposes a more intimate control than that which could be expected in even the closest knit family, decisions refusing to recognize a reallocation of income within the family group possess a special significance here. Indeed, in considering the effect of these agreements it should not be overlooked that they do not result from any arm's length bargaining, for, as is also apparent from their very terms, the parent corporation dictated their provisions. Agreements of such a nature can scarcely be expected to establish the realities of the situation. Cf. *Bourjois, Inc.* v. *McGowan*, 85 F. 2d 510 (C. C. A. 2d); *Campana Corp.* v. *Harrison*, 114 F. 2d 400 (C. C. A. 7th); *Campana Corp.* v. *Harrison*, 135 F. 2d 334 (C. C. A. 7th). For example, the taxpayer, Air Reduction Sales Company, owned assets in excess of $16,000,000 during the taxable year, its net sales of goods during that period were more than $15,000,000, its cost of producing these goods ex-

ceeded $4,800,000 and its net income after all deductions was $3,314,891.10. (R. 10; Respondents' Exhibit C.)[7] *Despite all this, the taxpayer, Sales, would have the Court conclude that its earnings were only $750.*

A taxpayer that owns assets of such magnitude, that utilizes them, together with the services of numerous employees, to manufacture products which can be sold at so large a profit, cannot, as a matter of reality, be said to do so for a purely nominal consideration—a consideration, it should be noted, which has no possible relationship to the value of its property and services, and which results from a transaction in which it is not a free agent. Its own books show that Air Reduction Sales Company had net income in excess of $3,000,000. The parties cannot, by their own *ipse dixit,* rewrite their tax bills so that these earnings shrink to $750. To permit such a result is to offend the principle that tax consequences flow from the substance of a situation, not from the forms by which it is described. *Gregory* v. *Helvering,* 293 U. S. 465; *Minnesota Tea Co.* v. *Helvering,* 302 U. S. 609; *Griffiths* v. *Commis-*

[7] National Carbide Corporation owned assets of more than $1,600,000, its net sales were in excess of $3,000,000 and its net income was $881,544.30. It was entitled to only $300 under its "agency" contract. (R. 9–10; Respondents' Exhibit A.) Pure Carbonic, Inc., owned assets of more than $2,000,000, its net sales exceeded $4,000,000 and its net income was $157,895.25. It was entitled to only $300 under its "agency" contract. (R. 11; Respondents' Exhibit B.)

sioner, 308 U. S. 355; *Higgins* v. *Smith,* 308 U. S. 473; *United States* v. *Joliet & Chicago R. Co.,* 315 U. S. 44; *Lucas* v. *Earl,* 281 U. S. 111; *United States* v. *Phellis,* 257 U. S. 156.

C. NO PRINCIPLE PERMITS THE CORPORATIONS' INCOME TO BE REGARDED, AT ITS INSTANCE, AS HAVING BEEN EARNED BY THE SOLE STOCKHOLDER

We believe that the foregoing demonstrates that the Court of Appeals was undeniably correct in sustaining the Commissioner's deficiency determination. That conclusion may be confirmed by an analysis of the objections to it raised by the Tax Court and by the taxpayers.

The Tax Court thought that while, normally, the corporate identity is to be respected, and that its income remains separate from that of its stockholders, there are exceptions to this and that the present case constitutes such an exception.

Southern Pacific Co. v. *Lowe,* 247 U. S. 330, was principally, if not exclusively, relied on by the Tax Court as the authority establishing such an exception in the case of a subsidiary corporation which is operated by its parent stockholder as "a mere department or agency," and it concluded (R. 32) that when the facts of the present cases "are viewed together they bring petitioners [taxpayers] within the rule announced by the Supreme Court in *Southern Pac. Co.* v. *Lowe, supra.*" An analysis of that case, however, will demonstrate that no such rule of law was announced. Neither that case nor any other deci-

sion of this Court supports the Tax Court in its unwarranted disturbance of the basic structure of the taxing statute in which Congress taxed the corporation, not its sole stockholder, on the corporation's earnings.

Southern Pacific Co. v. *Lowe* involved, as a taxpayer, a parent corporation which owned all the capital stock of a subsidiary. The subsidiary owned certain property, which formed a part of the railway system operated by the parent, and had leased all its property to the parent. Under the terms of the lease, the subsidiary was to receive $10,000 per year for organization expenses and, in addition, all net profits from the operation of the property, except that the parent was to retain one-half of the profits in excess of six percent on the capital stock of the subsidiary. Advances by the parent on behalf of the subsidiary were to bear lawful interest and the parent could reimburse itself at any time for such advances out of earnings in its possession. Necessary funds for additions and betterments or for making up deficits in earnings were advanced by the parent. The subsidiary had no bank account of its own, its earnings being deposited in the parent's bank account.

As a result of the payments due it under the lease and on account of the conversion of certain of its assets, the subsidiary had a large book surplus accumulated as of January 1, 1913, largely in the form of a debit against the parent.

During the first six months of 1914, dividends were declared by the subsidiary, part of which was out of the pre-1913 surplus. No cash was transferred, however, the dividend payments being effectuated by bookkeeping entries which reduced the subsidiary's surplus and also reduced the apparent indebtedness of the parent to the subsidiary.

The issue in the case was whether, *to the extent that the dividends were out of pre-1913 earnings*, the parent realized income which would be taxable to it under Section II G (a) of the Income Tax Act of 1913, c. 16, 38 Stat. 114. Noting that Congress had not attempted to tax income accruing to a taxpayer prior to March 1, 1913 (the effective date of the first income tax law enacted under the Sixteenth Amendment), the Court held that it was the intent of Congress (p. 337)—

> to refrain from taxing that which, in mere form only, bore the appearance of income accruing after that date, while in truth and in substance it accrued before; * * *

After referring to the fact that the parent was in complete control of the subsidiary because of the stock ownership, that the funds were in its actual possession at all times, both before and after the dividend, and that it was a matter of real indifference to the parent when it caused the subsidiary to declare the dividend, the Court

concluded that the income in question had accrued to the parent prior to March 1, 1913, and was not taxable, saying (pp. 338–339):

> Under the circumstances, the entire matter of the declaration and payment of the dividends was a paper transaction to bring the books into accord with the acknowledged rights of the Southern Pacific; and so far as the dividends represented the surplus of the Central Pacific that accumulated prior to January 1, 1913, they were not taxable as income of the Southern Pacific within the true intent and meaning of the Act of 1913.
>
> The case turns upon its very peculiar facts, and is distinguishable from others in which the question of the identity of a controlling stockholder with his corporation has been raised.

A similar result under somewhat analogous facts was also reached in *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71.

The *Southern Pacific* case, in dealing with the parent's liability for tax on payments received by it from the subsidiary, decided nothing about the subsidiary being taxed on the income in the first instance, and thus had nothing to do with the issue presented here, namely, whether the subsidiary corporation is the owner of the earnings to which such income is taxable. Indeed, the record in that case shows that the subsidiary did file tax returns and did pay the tax on the

income which it received.* There was no claim that the subsidiary did not do so properly or that its relations with the parent company were such as to immunize it from liability for tax on its income.

The decision in the *Southern Pacific* case actually turns on the Court's conclusion that the substance of the situation was such that the income had accrued to the parent prior to 1913, and that Congress did not intend to tax income of that character even though, from a purely formal viewpoint, there was a technical realization after that time. This is clear from the actual facts in the case, for the parent company only contended that it was not taxable on such of the dividends as came from pre-1913 earnings. *It did not question its liability for dividends from post-1913 earnings,* and the record shows that it included in its income and paid the tax on such dividends (amounting to more than $3,500,000)

* No. 452, October Term, 1917, R. 183–185, Plaintiff's Exhibit O, being a letter from the Commissioner of Internal Revenue to the subsidiary (Central Pacific Railway Company) recommending additional excise taxes on income for the years 1909–1912; R. 186–189, Plaintiff's Exhibit P, being the income tax returns of the subsidiary for the calendar year ended December 31, 1913, and for the six months ended June 30, 1914; R. 190–191, Plaintiff's Exhibit Q, showing changes made by the Internal Revenue Department in the subsidiary's return of annual income for the fiscal years ended June 30, 1910, to June 30, 1914; R. 192, Plaintiff's Exhibit R, showing income and profit and loss on which the subsidiary paid income tax for the fiscal years ended June 30, 1910, to June 30, 1914.

which were received from the subsidiary during the first six months of 1914.[9] Indeed, the amount of the dividends from the subsidiary on which the parent conceded it was taxable greatly exceeded the amount of the dividends which it was claimed did not constitute income to the parent. And this Court explicitly stated that its ruling applied only (247 U. S. at 338) "so far as the dividends represented the surplus of the Central Pacific [subsidiary] that accumulated prior to January 1, 1913 * * *."

That the case dealt only with pre-1913 earnings and their accrual to the parent prior to that time is not only clear from the issue as presented and decided, but it is also plain from the contemporaneous ruling in *Lynch* v. *Hornby*, 247 U. S. 339, in which it was held that Congress intended to tax an ordinary stockholder on a dividend received after March 1, 1913, even though paid out of earnings accumulated by the corpora-

[9] The opinion of the District Court, 238 Fed. 847, 848 (S. D. N. Y.), shows that the parent received dividends of $912,497.48 on January 13, 1914, and states that this "* * * represents only a portion of the dividend paid on January 13, 1914, which the plaintiff claims exceeded the net earnings of the company during the period." The dividends actually received on that date totaled $4,036,530, of which $3,124,032.52 were included in the parent's tax return, the balance of $912,497.48 being excluded because not paid out of post-1913 earnings. The parent also received a dividend on June 30, 1914, on preferred stock of $522,000, which amount was also included in its tax return. See No. 452, October Term, 1917, *supra*, R. 148, Plaintiff's Exhibit 2-H.

tion prior to that time. The Court pointed out that it was the congressional intent to tax a stockholder on his interest in the corporate profits at the time when it came into fruition through the receipt of dividends, and declared that there were no constitutional obstacles to this even though the dividends came out of pre-1913 earnings. *Lynch* v. *Hornby, supra,* in regarding *Southern Pacific Co.* v. *Lowe, supra,* as resting upon (p. 346) "special facts," and being "plainly distinguishable," showed that the Court was of the undoubted view that the parent's interest in the subsidiary's earnings there had come to fruition and had accrued prior to the occurrence of the paper dividend transaction and prior to the operative date of the taxing statute. This follows inescapably from the Court's extraordinary statement in the *Southern Pacific* opinion itself (p. 338) that "the case turns upon its very peculiar facts."

It is thus not surprising that subsequent decisions of this Court have recognized that the *Southern Pacific* and *Gulf Oil Corp.* cases have little or no precedential value. Thus in *Burnet* v. *Commonwealth Imp. Co.,* 287 U. S. 415, 420, the Court said that those cases—

> cannot be regarded as laying down any general rule authorizing disregard of corporate entity in respect of taxation. These cases presented peculiar situations and

> were determined upon consideration of them. * * *

See also *Moline Properties* v. *Commissioner*, 319 U. S. at 439, in which this Court said that the *Southern Pacific* and *Gulf Oil* cases have been "held to lay down no rule for tax purposes." The court below, in its decision here and also in *Nixon* v. *Lucas*, 42 F. 2d 833, 835, has similarly held that those cases are not applicable in other situations.

Southern Pacific Co. v. *Lowe*, 247 U. S. 330, in construing the 1913 Act and in ruling on what had become income prior to 1913, decided nothing germane to the issue here for it did not purport to decide that in any situation involving post-1913 earnings, the income of a corporation would ever be taxable to anyone other than the corporation itself. Indeed, every subsequent decision of this Court has demonstrated that the corporation cannot shift its tax liability to even its sole stockholder. The Tax Court, accordingly, was altogether mistaken in thinking that the situation here was completely governed by the decision in *Southern Pacific Co.* v. *Lowe, supra.*[10]

[10] The Tax Court relied on two other cases, both decisions of Courts of Appeals, for the proposition that the situation here authorized the disregard of corporate entities. Neither decision constitutes such authority. *Munson S. S. Line* v. *Commissioner*, 77 F. 2d 849 (C. C. A. 2d), which did not involve any question concerning the proper corporation to which income is taxable but, instead, had to do with a special credit granted by Section 23 of the Merchant Marine Act of

The taxpayers seek to present the matter as though *Southern Pacific Co.* v. *Lowe* merely decided that income collected by an agent is taxable to the principal rather than to the agent (Br. 11, 15–21) and that the Tax Court in the present case merely decided that the subsidiary corporations were agents of the parent, so that the income in controversy was taxable to the principal (Br. 11–12, 14–15, 17, 18–19, 25, 28). We believe that both of the above assumptions are without foundation.

Southern Pacific Co. v. *Lowe* did not decide that a principal's income is taxable to the principal rather than the agent and that such a relationship existed between the parent and the subsidiary company there. This should be amply clear from the foregoing analysis of the case,

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1920, c. 250, 41 Stat. 997, is best explained by the court below which decided that case. The opinion here (R. 278) states:

> Our decision in *Munson S. S. Co.* v. *Commissioner*, *supra*, depended upon the particular statute involved; we held that the encouragement to shipbuilding, which Congress had proffered to builders, was an overriding consideration, which should be recognized, regardless of the form employed.

The same explanation of that case was given by this Court in *Moline Properties* v. *Commissioner*, 319 U. S. at 439.

North Jersey Title Ins. Co. v. *Commissioner*, 84 F. 2d 898 (C. C. A. 3d), is without authority as a precedent for it was one of the cases giving rise to the conflict in decisions, on the basis of which certiorari was granted in *Moline Properties* v. *Commissioner*, 319 U. S. 436, fn. 1. The reasons which the Court there had relied on as permitting the corporate entity to be disregarded were demonstrated to be erroneous by the *Moline Properties* decision.

with particular reference to the fact that there was no issue concerning the corporation to which the subsidiary's income was taxable and to the fact that the parties had paid their taxes on the assumption that no principal-agent relationship existed. Further, if a simple decision concerning the taxable consequences of a principal-agent relationship (a relationship which is quite frequent in the business world) were all that was contained in the opinion, there would have been no need for the court to issue precautionary statements concerning the peculiar facts involved and concerning the absence of a rule of general applicability in the decision.

Also, there is no factual basis for concluding that the subsidiary in *Southern Pacific Co.* v. *Lowe* was an agent of the parent in the technical sense of that word. The subsidiary there, by leasing its property to the parent and by merely collecting the rental from the parent, was certainly not acting on behalf of the parent as an agent would for its principal. Accordingly, when the court in the *Southern Pacific Co.* case referred (p. 337) to the subsidiary there as being the parent's "agent", it did not give that word its common legal meaning.

The factual dissimilarity between the cases is also apparent. There, the subsidiary owned the property and the source of its income was the rental payments made to it by the parent; it was the parent which utilized the property, which

conducted the business, and which created the profits. In the present case the contrary is true. The subsidiaries here own the property, they carry on the business which realizes income from outside sources, and they create the profits; the parent here, like the subsidiary in the *Southern Pacific* case, derives its income only through an affiliated corporation. As a result, the reference in the *Southern Pacific* opinion to the subsidiary as an agent (whatever may have been meant by that term) is totally inappropriate to the subsidiaries in this case.

D. THE TAX COURT DID NOT HOLD THAT THE TAXPAYERS WERE THE AGENTS OF THEIR PARENT CORPORATION

The Tax Court did not hold, as the taxpayers now contend (Br. 11–12, 14–15, 17, 18–19, 25, 28), that this was simply the case of one corporation acting as an agent for another. Indeed, as we will show (*infra*, pp. 46–50), if the Tax Court had so held there would have been no substantial support in the record for such a conclusion. The Tax Court's decisions in these cases are actually based on the assumption that the relationship between the subsidiaries and the parent justified it in disregarding the separate existence of the subsidiaries for tax purposes. That this was the thread of the Tax Court's opinion is overwhelmingly clear from the reasoning which it employed.

We refer to the following portions of the Tax Court's opinion as support for our construction of it, a construction which was concurred in by

the Court of Appeals. At the outset, after stating the contentions of the parties, the Tax Court made this initial observation (R. 29):

> It requires scant citation of authorities to establish the principle that normally corporations are separate juristic persons and are to be so treated for tax purposes. See *Burnet* v. *Commonwealth Improvement Co.*, 287 U. S. 415, 11 AFTR 1099. Likewise mere ownership by one corporation of all of the stock of a subsidiary does not of itself merge the two corporations or create the relationship of principal and agent between them. *There are exceptions, however, particularly where the subsidiary is so much a part of the parent in its operations that it amounts to no more than a mere department or agency.* [Italics supplied.]

If the Tax Court were speaking of a simple principal-agent relationship, there would, of course, have been no reason to talk in terms of "exceptions." This is apparent for, after referring to the authorities relied on by both sides, the Tax Court said (R. 30):

> We have carefully examined the authorities cited by petitioners [taxpayers] and respondent and have studied them in the light of the facts present in the instant case and we think that the facts which we have here bring petitioners [taxpayers] within the ambit of the cases relied upon

by them rather than those relied upon by respondent.

The cases relied on by the taxpayers to which the Tax Court was there referring were: *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Munson S. S. Line* v. *Commisisoner*, 77 F. 2d 849 (C. C. A. 2d); *North Jersey Title Ins. Co.* v. *Commissioner*, 84 F. 2d 898 (C. C. A. 3d). In none of those cases was there any principal-agent relationship. See Fn. 10, *supra*, pp. 37–38.

The Tax Court's reliance on *Southern Pacific Co.* v. *Lowe, supra*, also demonstrates that it did not conceive of this case as one simply involving a principal-agent relationship for it said (R. 30):

> The Supreme Court in *Southern Pac. Co.* v. *Lowe, supra*, held that the distributions which were in issue in that proceeding were not dividends for the reason that the Central Pacific and Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former as stockholder and in other respects. The Court said in part:
>
> > * * * While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control. * * *

> We think the foregoing words of the Supreme Court are aptly descriptive of the relationship which existed between petitioners and their parent, Airco, in the instant case. * * *

The Tax Court then proceeded (R. 30–32) to refer at length to the detailed circumstances of the present cases (very little of which had anything to do with the so-called agency contracts) and then concluded by saying (R. 32):

> It is true, of course, that taken separately some of the foregoing facts would not be sufficient in themselves to make inoperative the general rule that corporations are separate juristic persons and are to be so treated for tax purposes. We think, however, that when all these facts are viewed together they bring petitioners within the rule announced by the Supreme Court in *Southern Pac. Co.* v. *Lowe, supra.*

Accordingly, we believe it clear from the whole tenor of the Tax Court's opinion that it did not purport to rest its decision on any narrow grounds of principal-agent, only lately invoked by the taxpayers in an attempt to justify the Tax Court decision. As has already been demonstrated, the grounds on which the case was actually decided were erroneous; as we shall show (*infra*, pp. 44–52) the decision would have been equally wrong if the Tax Court had decided the case in the manner in which the taxpayers contend that it was decided.

Finally, before proceeding to analyze the defects of the taxpayers' "agency" argument, we wish to deny emphatically the assumption which is made throughout their brief (pp. 9, 10, 11–12, 15, 17, 18–19) to the effect that the Court of Appeals, while recognizing that the subsidiaries were agents of the parent, refused to hold that the income should be taxed to the principal. From the prior analysis of the Tax Court's opinion, it should be sufficiently clear that such a problem did not even exist. The failure of the Court of Appeals to comment on the "agency" argument may be a silent reflection on the merits of those contentions. It certainly is not a naive legal conclusion by Judge Learned Hand that a principal's income is taxable to his agent. It is true that in *Railway Express Agency v. Commissioner*, 169 F. 2d 193, 196 (C. C. A. 2d), petition for a writ of certiorari filed August 27, 1948, No. 247, this Term, the majority opinion of Judge Clark (who did not participate in the present case) referred, by way of dictum, to the subsidiaries here as agents of the parent (Pet. Br. 12, 15, 19). But that dictum clearly does not represent a studied evaluation of the present cases.

E. THE TAXPAYERS DID NOT ACT AS AGENTS FOR THEIR PARENT CORPORATION

In the light of the preceding discussion, there are fairly obvious answers to the taxpayers' principal contention, namely, that this is the simple

situation of an agent acting for a principal, with the agent collecting money which is the principal's income. Of course, since the Tax Court neither analyzed nor determined the issue in this manner, in demonstrating the fundamental defects of the taxpayers' assertions, the evidence must be reappraised to a certain extent.

The Commissioner does not at all negate the proposition that where a principal-agent relationship exists, the principal's income is taxable to him, not to the agent, even though the money may pass through the agent's hands when collected by him for transmission to his principal. Nor is it denied that, in proper circumstances, a principal-agent relationship may exist between related corporations as it may between members of a family. Of course, when a close affinity exists between taxpayers who purport to act in that capacity, a careful scrutiny of the arrangement is proper to determine whether they are actually serving in a representative capacity or whether the arrangement, in effect, is an attempt to deflect taxable income from one entity to another.

If the subsidiaries here were acting as agents for the parent, as the taxpayers contend, they ought to be able to show in what respects they acted as agents, and what was the extent of their authority as agents. It is surprising, therefore, that, making no attempt to document the conclu-

sion which they (not the Tax Court) draw, the taxpayers should be content to say (Br. 14):

> The record is full of evidence establishing the principal-agent relationship. This Court need not review that evidence. It is fully reflected in the findings of the Tax Court charged with the determination of fact matters in tax cases.

Actually, the undisputed facts do not in any way justify the conclusion that the subsidiaries were acting as simple agents for the parent and that they were merely collecting money which was income pertaining to the parent. The contract between the parent corporation and the taxpayer, Air Reduction Sales Company (set out in full at pp. 6–8, *supra*), for example, states in part that (R. 13):

> First.—Airco hereby employs Sales as its agent to manage and operate, during the term of this contract, all plants for the production of oxygen, acetylene and other gases and for the manufacture of apparatus and containers for the utilization and transportation of such gases, which it or its subsidiary or controlled companies now own or control, or which it or they may hereafter build or acquire; and likewise employs Sales as its agent to market and sell, during the term of this contract, the output of all such plants.

These recitations of the contract, at first blush, would give the impression that the subsidiary was

merely employed as an agent to operate facilities belonging to the parent. The undisputed facts, however, are conclusively to the contrary. See pp. 16–30, *supra*. As we have seen, the subsidiaries owned all the manufacturing plants and facilities used in their respective businesses (with the exception of the gas cylinders previously referred to) so that they could not possibly have been acting as agents for the parent in the manner described by the contract.

Furthermore, if the subsidiaries were acting as agents so that the profits of the business were truly those of the parent, as principal, it would have to follow that the losses would also be those of the parent. Yet the contract, while requiring the subsidiaries to incur all expenses, nowhere states that they do so as agents of the parent or requires the parent to reimburse the subsidiary to the extent that expenses exceed income.

Even under common law concepts, it is essential to the creation of the principal-agent relationship that the agent be empowered to "bind" his principal in some respects. In the words of the *Restatement of the Law of Agency*, Sec. 12:

> An agent or apparent agent holds a power to alter the legal relations between the principal and third persons and between the principal and himself."[11]

[11] Comment (a) to this section states, in part:

> The exercise of this power may result in binding the

The subsidiaries possessed no authority to alter legal relations between the parent and anyone else. They certainly did not in the operation of the plant and machinery which they themselves owned. They certainly did not when they purchased supplies and equipment, for it is undisputed that the subsidiaries acquired title to such assets. They certainly did not when they sold their own products to the public. These matters being true and undisputed, it is impossible to conclude that they held the profits from those sales as an agent would when he sells property belonging to his principal.

The mere recitation of an agency relationship does not establish one. Where, as here, the undisputed facts show that the corporation is using its own property in the conduct of the corporate business, it cannot, as a matter of law, be regarded as using its property as an "agent" for the stockholder. In *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415, the Court refused to relieve the corporation from tax on gains attributable to the sale of its property to its sole stockholder; to the argument that the corporation was

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principal to a third person in contract; in divesting the principal of his interests in a thing, as where the agent sells the principal's goods; in the acquisition of new interests for the principal, as where the agent buys goods for the principal; or in subjecting the principal to a tort liability, as where a servant, while acting within the scope of his employment, injures a third person. * * *

merely an agency or instrumentality of the single stockholder, the Court replied (p. 420):

> The situation is not materially different from the not infrequent one where a corporation is controlled by a single stockholder.

Again, in *Moline Properties* v. *Commissioner*, 319 U. S. 436, where the corporation also attempted to be relieved from tax on gains resulting from the sale of corporate property, and where the argument was also advanced that the corporation was an agent for its sole stockholder, the Court said (pp. 440–441):

> There was no actual contract of agency, nor the usual incidents of an agency relationship. Surely the mere fact of the existence of a corporation with one or several stockholders, regardless of the corporation's business activities, does not make the corporation the agent of its stockholders. Therefore the question of agency or not depends upon the same legal issues as does the question of identity previously discussed. * * *

The present cases, too, do not present the usual incidents of an agency relationshp. The situation here differs from the *Commonwealth Imp. Co.*, *Moline Properties*, and *Joliet & Chicago R. Co.* cases only in that here the parties have gone through the motions of calling each other "principal" and "agent." We submit, however,

that if, in the *Commonwealth Imp. Co.* and *Moline Properties* cases, the corporations had purported to sell their corporate properties as "agents" for their stockholders, or if in the *Joliet & Chicago R. Co.* case the corporation had purported to lease its property as "agent" for its stockholders, the tax results would have remained the same. The concept of the derivative rights of the stockholders with respect to the property and profits belonging to the corporation are too fundamentally rooted in the taxing statute to permit the tax results to be altered by the simple expedient of adopting nomenclatures which do not aptly describe the true legal relationships among the parties.

We believe that much significance is to be attached to legislative action with respect to the manner in which affiliated corporations can compute their tax liabilities. When Congress desired or permitted such corporations to be taxed as a group, it knew how to do so. Thus, during the period from 1918–1933, Congress permitted the consolidation of earnings or losses of related corporations by provisions allowing the filing of consolidated returns.[12] However, it is of the greatest importance that the privilege of filing

[12] Section 240, Revenue Act of 1918, c. 18, 40 Stat. 1057; Sections 240 and 1331, Revenue Act of 1921, c. 136, 42 Stat. 227; Section 240, Revenue Acts of 1924, c. 234, 43 Stat. 253, and of 1926, c. 27, 44 Stat. 9; Section 142, Revenue Act of 1928, c. 852, 45 Stat. 791, and Section 141, Revenue Act of 1932, c. 209, 47 Stat. 9.

such returns, except for a limited class of corporations, was withdrawn by the Revenue Act of 1934[13] and was not available during the taxable year involved here. Also, while the privilege of filing consolidated returns was subsequently extended, Congress provided for an addition to the tax rate and a more limited exemption where the privilege is exercised.[14] It is submitted that affiliated corporations cannot, by the simple expedient of utilizing convenient contracts, create for themselves the authority of consolidating their corporate incomes when Congress has not seen fit to extend to them the privilege of filing consolidated returns.

If an agreement of the nature involved here (whether called an agency agreement or anything else) were to have the effect of shifting tax liabilities from the corporation, the net result would be to permit the corporate entity to be disregarded, for tax purposes, at the will of the stockholder. If the stockholder can at once have all the advantages that flow from utilizing the corporate form and, at the same time, for tax purposes, claim that the corporation is his agent and

[13] Section 141, Revenue Acts of 1934, c. 277, 48 Stat. 680, of 1936, c. 690, 49 Stat. 1648, of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code.

[14] See Section 141 of the Internal Revenue Code, as amended by Section 159 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, Sections 131 and 204 (c) of the Revenue Act of 1943, c. 63, 58 Stat. 21; and Section 2 (c) of the Tax Adjustment Act of 1945, c. 340, 59 Stat. 517.

that its earnings (save only those that he permits it to retain) are taxable only to him, then the legislative purpose of taxing the corporation as a separate entity and of taxing the stockholder on the derivative income which he receives, is reduced to naught. The Court undoubtedly had this in mind in the *Moline Properties* case, *supra*, when it observed (319 U. S. at 440–441) "the question of agency or not depends upon the same legal issues as does the question of identity previously discussed."

F. THE TAXPAYER CORPORATIONS, BY AGREEING TO PAY THEIR PROFITS TO THEIR PARENT STOCKHOLDER, DID NOT INCUR DEDUCTIBLE BUSINESS EXPENSES

The taxpayers advance what purports to be an alternative argument (Br. 21–24), namely, that the taxpayers should be permitted to deduct as ordinary and necessary business expenses under Section 23 (a) (1), Revenue Act of 1938, Appendix, *infra*, pp. 61–62, their profits which they had agreed to pay to the parent stockholder. When examined for substance, this argument will be found to be only another way of attempting to have a corporation's entity disregarded and the true relationship between it and its stockholders ignored.

At the outset, it should be clear that there is no question concerning the deduction by the taxpayers of the normal business expenses which were

actually incurred by them in the conduct of their respective businesses. Such direct expenditures as were incurred by the taxpayers were allowed as deductions by the Commissioner (R. 9–12, 36–42). Indeed, in order "clearly to reflect the income" of the taxpayers, the Commissioner added to the amounts deductible by the taxpayers approximately $400,000 of expenditures which were incurred directly by the parent. (R. 6–7, 40.) In doing so, the Commissioner acted under Section 45 of the Revenue Act of 1938, Appendix, *infra*, p. 62.

What the taxpayers are now asking to have allowed as a business deduction consists, not of the expenses incurred in earning their profits, but of the very profits themselves. They seek to do so on the ground that they have agreed to pay those profits to their stockholder because the stockholder supplied them with their capital.

We submit that when Congress imposed an income tax on corporations, it was never intended that a corporation should be able to insulate its profits against the operation of the statute by agreeing that the corporate profits should belong to the stockholder in consideration of his having enabled the corporation to acquire and own its assets. Since the relationship between the stockholder and the corporation presupposes that the stockholder's investment in the corporation will

enable the corporation to acquire its assets, and since the stockholder will become entitled to share in the corporation's profits and property only as they may come to him in the form of dividends or on dissolution, it is manifest that an agreement by the corporation to pay its profits directly to the stockholder will not relieve the corporation from tax. See *United States* v. *Joliet and Chicago R. Co.*, 315 U. S. 44, and the discussion, pp. 25–30, *supra*. Cf. *Raybestos-Manhattan Co.* v. *United States*, 296 U. S. 60. We believe that this is inherent in the statute.

We contend further, as a matter of law, that where a corporation does enter into such an agreement, it does not incur an expense deductible under the express terms of Section 23 (a) (1). In view of what has been said, it is clear that it is neither an "ordinary" nor a "necessary" expense for a corporation to agree to pay over its profits to its stockholder.[15]

The parent stockholder here, for reasons satisfactory to it, saw fit not to engage in the business of manufacturing and selling products directly.

[15] The taxpayers' reliance (Br. 22–23) on *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, is greatly misplaced. That case held that the parent stockholder could not deduct as a business expense amounts paid to the subsidiary to make up an operating deficit. Even though the stockholder might, in other circumstances, be entitled to a similar deduction, it would not at all follow that the converse would be true, namely, that the corporation would be entitled to a deduction on account of profits which it has agreed to pay over to its stockholder.

It elected, instead, to have that done by separate corporations. The stockholder cannot enjoy those benefits without accepting the tax incidents which Congress has imposed by taxing the corporate income to the corporation. Nor can it alter those incidents by any arrangement which seeks to impute the corporate income to the stockholder, as a principal, when a true principal-agent relationship is lacking, or which seeks to permit the corporation to distort its income by deducting payments which it makes to its stockholder out of profits.

Finally, we desire to urge that if this be a true alternative contention, the taxpayers are improperly seeking to raise a new issue on appeal. The Commissioner's deficiency determinations were based only on the theory that the income of each taxpayer was attributable to it, as a separate corporation. (R. 40.) The taxpayers' petitions before the Tax Court (R. 36–42) controverted this only in respect to the question whether the income belonged to them or to the parent. There was no suggestion that some or all of the disputed income was, alternatively, deductible as a business expense. The rather extensive opening statement (R. 44–60) made on behalf of the taxpayers is devoid of any contention that such a question of deduction was in issue. Throughout the lengthy development of the facts in the trial of the case, there was no suggestion that a deduction under

Section 23 (a) (1) was involved. Nor was any such contention made in the taxpayers' brief before the Tax Court. Indeed, long prior to the conclusion of the testimony, pursuant to a question asked by the Tax Court Judge, counsel for both sides agreed that there was no issue concerning the amount of the expenses which the Commissioner in his deficiency notice declared to be deductible by the taxpayers. (R. 183.) This led the Tax Court to say in its opinion (R. 34):[16]

> Petitioners [taxpayers] make no contention that if they lose on this issue they are in the alternative entitled to deduct as business expenses the amounts of income which they turned over to Airco. They concede that if the issue which is raised by the pleadings is decided against them, then the deficiencies are those which have been determined by respondent [the Commissioner]. On the other hand, respondent concedes that if the issue raised by the pleadings is decided in favor of the petitioners, then there are no deficiencies.

The taxpayers, in their brief and on oral argument before the Court of Appeals made no con-

[16] While the taxpayers contend (Br. 24) that the Tax Court misunderstood counsel, this is a decided after-thought for, until now, the accuracy of the above-quoted portion of the Tax Court's opinion has never been challenged. Actually, a fair reading of the exchange between counsel and the Tax Court Judge affirms the Tax Court's understanding of the matter—a conclusion which would have been clear from the pleadings even in the absence of this concession.

tention respecting the deductibility of these amounts as a business expense.

It was not until the taxpayers' petition for rehearing in the Court of Appeals (R. 284–287) that there was any attempt to raise an issue concerning the deductibility of the payments which the taxpayers agreed to make to their stockholder.

If there were any substance to this contention, it would plainly come too late at this stage of the proceedings after the factual record had been completed. Whether expenses are "ordinary" and "necessary," whether they were "paid" and even whether they were "incurred in carrying on" a trade or business raise, in some respects, questions of simple fact. *Commissioner* v. *Heininger*, 320 U. S. 467, 475. The taxpayers cannot interject such issues now. *Bankers Coal Co.* v. *Burnet*, 287 U. S. 308; *General Utilities Co.* v *Helvering*, 296 U. S. 200.

II

THE COURT OF APPEALS POSSESSED AUTHORITY TO REVERSE ERRONEOUS DECISIONS OF THE TAX COURT

There remains the question whether the court below exceeded its powers of review when it sustained the Commissioner's deficiency determinations and reversed the Tax Court for having failed to do so. If we are correct in our view

that the Tax Court decided the cases by the application of erroneous legal principles, the Court of Appeals possessed full authority to correct decisions which were not in accordance with law. Section 1141 (c) of the Internal Revenue Code, which was applicable when the cases were decided by the Court of Appeals, expressly provides that the reviewing court may reverse such a decision, a matter which was affirmed by *Dobson* v. *Commissioner*, 320 U. S. 489, 492–493, rehearing denied, 321 U. S. 231, and by cases in which Tax Court decisions have been overturned. See *McWilliams* v. *Commissioner*, 331 U. S. 694; *Crane* v. *Commissioner*, 331 U. S. 1; *Commissioner* v. *Wilcox*, 327 U. S. 404; *Commissioner* v. *Estate of Holmes*, 326 U. S. 480; *Trust of Bingham* v. *Commissioner*, 325 U. S. 365, and cases cited p. 371, fn. 1.[17]

In this connection, the taxpayers' contention that the Court of Appeals had no authority to reverse the Tax Court (Br. 25–28) is colored by the erroneous assumption made here and elsewhere in their brief, namely, that the Tax Court

[17] Section 1141 (a) of the Internal Revenue Code was amended by Section 36 of the Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess., so as to make the decisions of the Tax Court subject to review by the Courts of Appeals "* * * in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury * * *." Section 38 of that Act provides that its provisions should take effect on September 1, 1948.

was merely deciding a simple fact question whether a principal-agent relationship existed. As we have already shown, pp. 40–44, *infra*, such was not the nature of its decision.

Moreover, even if the cases could be regarded as instances of those in which the Tax Court makes evidentiary determinations, it does not at all follow that its conclusions are immune from reexamination by the reviewing courts. Unless there is some rational basis in the record to support those conclusions, the Tax Court's decision is erroneous and subject to reversal no less than where it has applied erroneous legal principles. Here, if the existence of a principal-agent relationship sufficient to make the parent the taxable earner of the income be stressed, or if the broader scope of the entire record be analyzed, we submit that there is no rational foundation to support the Tax Court's decisions. See pp. 15–30, 44–52, *supra*.

Accordingly, the Tax Court's ultimate conclusion that the parent, rather than the subsidiaries, is the taxable owner of the income is no less erroneous and no less required to be reversed than was its decision that the embezzler was the taxable owner of the income in *Commissioner* v. *Wilcox*, 327 U. S. 404. The Court of Appeals was altogether correct in reversing the erroneous decisions of the Tax Court.

CONCLUSION

The decisions of the Court of Appeals should be affirmed.

Respectfully submitted.

PHILIP B. PERLMAN,
Solicitor General.
THERON LAMAR CAUDLE,
Assistant Attorney General.
STANLEY M. SILVERBERG,
ELLIS N. SLACK,
LEE A. JACKSON,
HILBERT P. ZARKY,
Special Assistants to the Attorney General.

DECEMBER 1948.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 13. TAX ON CORPORATIONS IN GENERAL.

* * * * * *

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation the net income of which is more than $25,000 * * *.

* * * * * *

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for

salaries or other compensation for personal services actually rendered; * * *

* * * * *

SEC. 45. ALLOCATION OF INCOME AND DEDUCTIONS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

SEC. 602. EXCESS-PROFITS TAX.

(a) If any corporation is taxable under section 601 with respect to any year ending June 30, there is hereby imposed upon its net income for the income-tax taxable year ending after the close of such year, an excess-profits tax equal to the sum of the following:

6 per centum of such portion of its net income for such income-tax taxable year as is in excess of 10 per centum and not in excess of 15 per centum of the adjusted declared value;

12 percentum of such portion of its net income for such income-tax taxable year as is in excess of 15 per centum of the adjusted declared value.

T. D. 4829, 1938–2 Cum. Bull. 98:

* * * * *

EXCESS-PROFITS TAX

REGULATIONS RELATING TO THE EXCESS-PROFITS TAX IMPOSED BY SECTION 602 OF THE REVENUE ACT OF 1938

* * * * *

ART. 2. *Scope of tax.*—The excess-profits tax, imposed by section 602 of the Revenue Act of 1938, is imposed upon the net income of every corporation for each income-tax taxable year ending after the close of any year ending June 30 in respect of which the corporation is subject to the capital stock tax imposed by section 601 of that Act.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 13–1. *Tax on corporations in general.*—Section 13 imposes an income tax on corporations in general the net income of which is more than $25,000.

* * * * *

ART. 22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. * * *

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